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Probing Real Economic Growth through Institutional Quality and Fiscal Policy in Pakistan

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Abstract- The study examined the effect of institutional development and fiscal policy on real economic growth.It employed Generalized Method of Moments (GMM) techniqueto deal with potential endogeneity, which may arise in the presence of institutions. Principal Component Analysis (PCA) is used to construct an index of institutional quality. The real economic growth in Pakistan covering the period from1984 to 2018 provides ample evidences that(i) tax rates have negative and insignificant impact on real economic growth (ii) public expenditures on social indicators helps in augmenting real growth (iii) link between institutional quality and real economic growth is positive but insignificant (iv) increase in investment pushes up real growth and lagged value of GDP also helps in promoting growth (v) trade openness restricts real growth. Accordingly, it is suggested that government should enhance expenditures on social indicators and for that purpose there is need to increase tax to GDP ratio through expanding the tax base; not the tax rate and it is vital to restructure institutions which help to improve economic growth; i.e. accountability, equity, security and transparency.

Keywords: Institutions, GMM, Political economy, PCA, Real economic growth.
JEL Classification: P16; O43; 020; C22

I. INTRODUCTION

Economic growth shifts production possibility curves, creates jobs and boasts business of nations. Without increase in GDP it is not possible to create jobs, reduce poverty and to minimize the extent of inequality among the masses. Economic growth does not show pattern of sustainability in Pakistan.In some years it showed notable growth whereas in other time periods this impetus was lost.The economy of Pakistan has expanded at striking average growth rate of 6% from the mid of 1970's to the mid of 1980's. From 1985 to 1995, the economy grew at an average percentage growth rate of 5.5%. Between 1997- 2002, economic growth portrays a gloomy picture. This occurred mostly as a result of infliction of economic sanctions by the world community after the nuclear explosion in1998. It influenced GDP growth unfavorably and left the country twirling around hardly more than 2% average growth rate during this period. Since 2005, the GDP in Pakistan is increasing at an average rate of 5% a year and this is not enough to meet the requirements of ever growing population. According to SBP annual report 2018-19 the growth rate in the economy is 3.29%. Pakistan is going through crises in these days.GDP growth in the FY 2020 is -0.38% (IMF anticipates GDP to drop by 1.5%). To avoid significant economic problems in the future, there is dire need to study the determinants of real growth in the context of fiscal policy and institutions.

The efficacy of fiscal policy for management of economic activities has always been keen interest of policy makers and researchers. Endogenous and Keynesian growth theories proved significant role of fiscal policy for economic growth.Fiscal indicator i.e. tax revenues, play a vital role for the sustainability of a country, as they are the main source of government revenue and fulfill the public and social requirements by providing government goods and services. In Pakistan, expenditures have always outpoured public revenues i.e. budget deficits have persisted for years and were often unsustainable (Ishfaq and Chaudhary, 1999).According to state bank of Pakistan, Public debt in September 2019 was Rs. 34.24 trillion which was 79% of GDP. The resource gap between public revenues and spending is shown in appendix. Thus the need of the hour is enhancement of tax-to-GDP ratio in Pakistan without having any negative influence on real economic growth.

There is an ample body of literature which has focused on relationship among mobilization of revenue and growth. The impact of these factors differs across nations due to their utilization, strategies applied and adequate financing of high return projects. Barro (1990) presented strong evidence in favor of the

view that higher taxes are growth-impending. There seems a similar case of Pakistan where tax rates are high and tax base is very narrow. For example income tax rates are as high as 35% and sales tax is over 17%. Barro (1990) results have been supported in some studies for instance, findings of (Madni, 2013), and(Engen and Skinner, 1992) confirm that growth rate is hampered by high taxes, while studies like (Koester and Kormendi, 1989), and(Ahmad & Wajid, 2013) do not identify significant impact of taxes on growth. This study will analyze the impact of taxes on real growth of Pakistan because there is contradictory debate among economists in this regard.

In this study, efforts have also been made to capture the impact of social indicators on real growth of Pakistan. Social indicators refer to the welfare of human beings or societies and in this study this variable is an aggregate measure of government expenditures on education and health. In Pakistan, expenditures on social indicators have never been the main focus of economic planning. In our country one-third of the children find no school to go for basic education and this is contrary to the article 25-A of the Constitution which ensures education as a basic right for every children for age ranging between five to 16 years. On the other hand health expenditures in Pakistan are low but persistently rising. Health is the basic right of citizens and it is vital precondition of development and growth. Pakistani government does not consider health as a priority area (Akram et al, 2007). Over the past ten years, the economy is disbursing 0.5 to 0.8 % of GDP on health services. According to World Health Organization standard, countries should spend at the minimum of 6 % of GDP on lifesaving and basic services (PES 2016-17). Clearly these percentages are much lower than the desired level. Since there is an inverted U shape relation between public expenditures and growth, this analysis is remarkably significant for Pakistan because given the resource constraint it helps the policy makers to gauge whether public expenditures on social indicators are growth promoting or not.

One of the functions of the state is to provide social order i.e. to build institutional quality. In Solow model, Ramsey-Cass-Koopmans model and New Endogenous growth models, the explanatory variables like institutions, infrastructure and culture have not been given much importance, generally because they are not considered leading variables. However these variables have gained much importance in the analysis of recent research; particularly Douglas North (1990) placed much importance to it. It is also well known that doctrine of evolutionary theory has linkages with the New Institutional Economics (NIE) as stated by Nelson and Winter (1982), as well as Douglas North (1990).

Nobel laureates, Douglass North, Oliver Williamson, and Ronald Coase, changed the early intuitions of new institutional economics into strong theoretical and logical tools that laid a strong base of experimental research. According to institutional economics, institutions are of vital importance in determining the destiny of the country. Unlike the neo-classical theories, it does not take institutions as given. The logic behind this claim is that some countries become developed because their institutional framework enhances agent efficient behavior, while others are facing problems because their institutional framework does not put off abusive behavior and methods that are ineffective, so there is frustration in investment and economic agents have hesitation to make contracts or agreements. Rodrik (2008) examined that countries without or poor quality institutions cannot become developed.

There is strong cross country empirical evidence that significance of institutions cannot be neglected in evaluating development level around the world (Acemoglu, Johnson and Robinson, 2001, Hall and Jones, 1999). Institutional framework plays an important role in economic activities. Effective institutions promote investment, growth, human resources, good governance and help to overcome conflicts, ethnic tensions and social aggression [Chu (2001), Aron (2000), North (1990), Dollar and Kray (2003), World bank (2002), Rodrik,et al. (2002), Jutting (2003)]. The weak institutional framework leads to poor governance as highlighted by Hassan (2002); Government of Pakistan (1999) and DRI/ McGraw-Hill (1998).This study will focus on 'whether Pakistan has witnessed improved governance overtime or serious work needs to be undertaken in augmenting real growth'.

From the above discussion it is clear that importance of institutions cannot be neglected in boosting growth. Ample literature has emerged to analyze the role of institutions in economic growth (Hare (2001), Assane et al. (2003), Knack & Keefer (1995)). This paper is first endeavor to my knowledge that has explored the joint effect of institutions and fiscal policy on real economic growth of Pakistan and prescribes policy implications for the same.

II. THEORETICAL FRAMEWORK

In this section, framework is developed to investigate the joint influence of institutions and fiscal policy on real economic growth of the economy. Barro (1990) developed a model in which households maximized their utility as given in equation (1). The initial model was for closed economy and households lived infinitely. Utility (U) is function of consumption (C).

$U=\int_0^{\infty} u(C)e^{-\rho t}\,dt$ (1)

Where C denotes the consumption of individual person and ρ is greater than *zero* and it shows that the time preference is constant. If the population growth rate is also kept constant then the utility function may be written as follows;

$u(C) = \frac{C^{1-\epsilon}-1}{1-\epsilon}$ (2)

Here ϵ > 0,

Rebelo (1991) assumed rate of return on capital as constant, hence, we can write production function of each household as follows:

$Y=Ak$ (3)

Here A is greater than 0, and represents 'stable net capital marginal product'.This production function can be adjusted to distinguish between human and physical capital.

When public sector is included in the study then it is assumed that (ga) is the extent of public amenities and these public amenities are considered as inputs in private sector production. Production exhibits constant returns in (ga) and (k) considered jointly but depicts diminishing returns to scale, when 'k' is considered independently. The production function may be written as follows:

$y= \Phi(k,ga)= \Phi(\frac{ga}{k})$ (4)

In the equation Φ fulfills the requirement of diminishing and positive marginal products. It is presumed that production function is Cobb-Douglas, and it is given as:

$\frac{y}{k} = \Phi(\frac{ga}{k}) = A(\frac{ga}{k})^{\alpha}$ (5)

Here $0 < \alpha < 1$. After simplifying, we get:

$y= Ak^{1-\alpha}ga^{\alpha}$ (6)

Here y depicts the output per capita; A is the factor of productivity and k stands for private per capita capital and (ga) shows public amenities. If public spending is backed up by a flat rate of income tax then;

$ga = R= ty = t.\Phi(\frac{ga}{k})$ (7)

Where R depicts revenue of the government, t shows tax rate and ga stands for aggregate spending. Equation (7) shows balanced budget constraint. However, in emerging economies, balanced budget is hard to observe, so Kneller *et al*. (1999) assumed unbalanced budget of government in certain periods. Now rephrasing equation (7) as,

$nga + Cg + u = Lt + \tau n y$ (8)

In the above equation u depicts budget surplus/deficit in a specified period. Lt and Cg stands for lump-sum taxes and government financed consumption (non-productive). Both are assumed to have zero influence on economic growth. The 'ga' represents public productive expenditures.Distortionary taxes are denoted by (τ). The expected signs of 'τ' and 'ga' are negative and positive. Ricardian equivalence holds if u is zero, otherwise it may not be zero (Bleaney *et al*., 2001).

In theory, private investment is not influenced by lump sum tax but proportional tax does influence private investment. Concerning this model, Barro and Sala-i-Martin (1992) obtained growth in the long term, as follows:

$\gamma = \delta(1-m)(1-\alpha)A^{\frac{1}{1-\alpha}}(\frac{ga}{y})^{\frac{\alpha}{1-\alpha}} - \sigma$ (9)

Where δ and σ are the parameters in the desired utility function. This equation shows that growth rate is negatively related to distortionary tax rate *m* and positively related to productive publicexpenditures (ga). In the above equation ga/y shows the ratio of useful public spending to GNP. If we have a Cobb-Douglas production function for public services with an exponent α, then growth rate will be maximized when $ga/y = \alpha$.

Both institutional (v_{it}) and fiscal (x_{jt}) variables in line with Kneller *et al*. (1999) are considered and hence growth equation becomes,

$y_i = \alpha + \sum_{i=1}^{k}\beta_i v_{it} + \sum_{j=1}^{m}\gamma_j x_{jt} + \epsilon_{it}$ (10)

Following is the general form to study the effect of institutions and fiscal policy on real economic growth:

$Y= \beta_0 + \beta_1 FV_t + \beta_2 V_t + \mu$ (11)

In the equation (11) 'FV' symbolizes the Fiscal variables and 'V' shows the institutional variables, along with control variables.

III. THE DATA AND ESTIMATOR

The data in this study covers the period from 1984-2018 for Pakistan. The data for variables is drawn from World Development Indicators, Pakistan Economic Survey (various issues), International Country Risk Guide, and Handbook of Statistics on Pakistan Economy. The study uses GMM (Generalized Method of Moments) regressions to deal with potential endogeneity, which may arise in the presence of institutions.Many authors like Aghion et al., (2004) and Greif&Laitin (2004) consider institutions as endogenous. According to Omri & Shaibi (2014)GMM estimators solve the potential endogeneity issues in independent variables by introducing instrumental variables. We will use the first lag of the independent variables as instruments in the model. GMM is predicated on the assumption that Laws of Large Numbers can be applied to sample averages and the Central Limit Theorem can be applied to scaled sample averages. Hansen's (1982) original presentation assumes that the data are stationary and ergodic, and conditions hold that allow the application of these limit theorems. Hence the stationarity check is not necessarily required in GMM estimations. Results regarding GMM will be covered in next section.

Table 1: Description of variables

Abbreviations	Detail
RGDP	Log of real GDP. Data is in million rupees.
TAXRATE	Log of real tax revenues as percentage of real GDP is used as a proxy for tax rate (Chuma, (2015) has used ratio of tax revenues to GDP as proxy for tax rate).
OPEN	Log of real trade where trade is (imports + exports)/2/GDP.
INVEST	Log of per capita real Investment (Private + Public).
IQ	The data of Institutional Quality variable is obtained by compiling various components of political risk from International Country Risk Guide (ICRG), these components are Ethnic tensions, Law and order, and External conflict. All of these variables range from 0-10. Where greater values indicate improved institutional framework and lesser values suggest poor quality. By taking all these variables, we developed an index of institutional quality (IQ) by PCA i.e. principal components analysis. In PCA technique we create a single weight index from uncorrelated and different variables.
LAG1RGDP	Log of GDP with one period lag. (We take GDP at constant factor cost. Here data is in million rupees).
GESI	It is an aggregate measures of public expenditures on social indicators i.e. education and health.

IV. GMM RESULTS

The results of GMM are given in table 2. It is apparent that the impact of tax rates on real economic growth is negative but the coefficient is insignificant. The negative sign is justified by Barro (1990), who is of the view that higher tax rate tends to reduce growth. Similarly,Engen and Skinner(1992) noted that increase in tax rates will impede growth rate.

The negative influence of taxes on economic growth is also noticed by Pasha (2018). Author is of the views that increase in tax-to-GDP ratio of over 3 % of GDP from the time period 2013 to 2017 is attributable to higher rates of taxes in Pakistan. According to him, high tax rates have serious repercussions for the growth of Pakistan economy. To prove this finding author quoted some examples as follows:

I. He observes that telecommunication sector has been susceptible to excessive taxation. It includes sales tax of 17 % and apart from that withholding tax has also been levied on mobile phone cards and telephone bills. The combined rate of tax is almost 32% and this leads to decline in the growth rate of mobile phone numbers to 2% from 8%. In recent times, Supreme Court of Pakistan has given a decision against high rate of taxes on mobile phone cards.

II. Rates of sales tax and import duty have been enhanced on furnace oil which is considered as an important fuel in electricity generation. Sales tax was enhanced from 17% to 20% and import duty increase from 0% to 11%. This has resulted in greater price of electricity. Such a scenario has significantly decreased the competitiveness of our products in international markets. As such, one of the reasons of reduction in exports after 2014 is the hike in taxes of furnace oil.

III. According to Pasha (2018), announcement of withholding tax on cash dealings in 2015, was an imprudent move. Such a step has led to a steep fall in the growth rate of bank deposits and consequently increases significant money in circulation.

Apart from that Pasha (2018) quoted other examples showing that increase in tax rates is hampering the economic growth of the country. Hence further enhancement of tax rates must be averted and efforts should be made to slowly move/shift them down.

However, the co-efficient of tax rates is weak. Levine and Renelt (1992) also did not succeed in finding a strong cross-country connection between fiscal policy variables and growth rates in the long run. The outcome that tax rates have insignificant effect on growth occurs possibly from two opposite effects of taxation. First, the negative effect results from disincentives and distortions created by taxes. This happens when tax revenues are spent on transfer payments. Second, if taxes are utilized to invest in public goods, then the taxes could have positive impact on growth rate.Hence such analysis justifies the insignificant coefficient of tax rates.

Table 2: Estimated GMM Results for Real Economic Growth

Dependent Variable : Real GDP
Technique: Generalized Methods of Moments

Variables	**Coefficient**	**Std.Error**	**t-Statistic**	**Prob.**
TAXRATE	-0.04	0.04	-1.06	0.30
IQ2	0.02	0.01	1.48	0.15
GESI	0.01**	0.01	2.09	0.05
OPEN	-0.05**	0.02	-2.33	0.03
INVEST	0.11**	0.05	2.24	0.03
LAG1RGDP	0.58*	0.21	2.76	0.01
C	4.43***	2.46	1.80	0.08
R2	0.98			
DW	1.78			
Prob(J-stat)	0.12			

Notes: The dependent variable is Real GDP. Institutional quality variable (IQ) is treated as endogenous. *, **and *** show significance at 1%,5% and 10% level respectively.
Source: Author's own calculations.
Model: *GDP = f (TAXRATE, OPEN, INVEST, IQ2, GESI, LAG1RGDP).*

Results show that investment has a positive and significant impact on the real economic growth. According to Ali & Ahmad (2010) this positive impact shows that high-level of investment raises the productivity and thus speeds up the process of real growth. Our results support such findings.

The coefficient of trade openness is negative, which may show uncompetitive prices of Pakistani products in the international market because of inflation rate and energy crisis in the nation. Moreover, Pakistan's exports are lower than imports and hence we do not gain much from the policies of free trade. For Pakistan economy, Ali & Abdullah (2015), also establish negative link between trade liberalization and economic growth. According to the authors, weak institutional framework has profound implications for the negative link between trade and economic growth.

The results (table 2) show positive link between institutional quality and real growth but the coefficient of institutional quality is insignificant. It is because of the fact that some institutions are strong and some are weak in Pakistan. Thus, there is a need to restructure certain main political institutions which help to improve economic growth, accountability, equity, security and transparency(Ishrat Husain, 2018).

As suggested by the theory, economic growth depends positively and significantly on its previous values. Next, the variable public expenditure on social indicators is an aggregate measure of public expenditures on education and health services. The coefficient of this variable is positive and significant. In Pakistan, the projected value of multiplier is nearby two and the multiplier effect of higher public sector development program (PSDP) is boosting economic growth of the country (Pasha, 2018). Hence the policy implication is that Pakistan should invest more on social indicators so that optimum level of real growth will be attained.

V. CONCLUSION

This study examines the effectiveness of public spending, taxes and institutional quality for economic growth. Literature on economic growth either throws light on the effect of tax rates or institutional development on economic growth. These previous studies have generally shown contradictory results regarding the impact of tax rates on economic growth while institutional development is considered impetus in stimulating economic growth. In this study joint effect of institutional quality and tax rates is explored on real economic growth of Pakistan. Moreover study makes endeavor to capture the impact of social indicators on real economic growth because limited work has been done in this dimension.

The study applied GMM regressions to deal with the possibility of endogeneity in the presence of institutions. The key outcomes of empirical investigations can be summed up as follows. First, the tax rates have negative influence on real economic growth but the coefficient is insignificant. Second, results showed that real economic growth is positively and significantly affected by social indicators in Pakistan. Third, there is positive and insignificant link between institutional quality and real growth. Fourth, the coefficient of trade openness is negative. Fifth, results illustrated that investment has a positive and significant impact on the real growth. Lastly, as suggested by the theory, results show positive and robust connection between real economic growth and its previous values.

To achieve our national goal of inclusive growth and socio-economic development, there is also a dire need of increasing public spending on social indicators i.e. quality health and education should be given due priority in Pakistan. Moreover, public policy should be devised with the sole objective of increasing Tax to GDP ratio through expanding the tax base, not the tax rate. Lastly, further restructuring of institutions can help to improve real economic growth.

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